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COLONIAL TRUST *Quarterly*

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CAPITAL MARKETS REVIEW

EQUITY MARKETS FINISHED THE YEAR ON A HIGH NOTE, WITH THE S&P 500 RETURNING 11.7% FOR THE FOURTH QUARTER AND DELIVERING 26.3% IN 2023.

The S&P 500 trailed the Dow Jones Industrial Average and the Nasdaq Composite for the quarter, which returned 13.1% and 13.8%, respectively. The Nasdaq was the strongest domestic index for the year, posting a total return of 44.7%. The fourth quarter began amid a sell-off, which was driven by higher interest rates. During October, the 10yr treasury yield continued its upward move, rising from 4.57% on September 30th to 4.99% on October 19th, the highest yield since 2007. November and December's economic and inflation data pointed to moderating growth and falling inflation. Then, December brought a more dovish tone from Jay Powell and the Fed, which signaled three interest rates cuts in 2024. These forces combined to bring the 10yr treasury yield from 4.99% all the way down to 3.88% at year-end. Falling rates caused nearly all assets to rally in the fourth quarter, and the year ended with the S&P 500 on a nine-week winning streak.

THE STRONG FOURTH QUARTER PERFORMANCE WAS NOT CONFINED TO LARGE CAP DOMESTIC STOCK INDICES.

International equities performed well, with the MSCI EAFE index of developed markets returning 10.5%, while the MSCI Emerging Market Index returned 7.8%. This emerging market index was weighed down by China. The iShares MSCI Emerging Market ex-China ETF had a total return of 12.5%. Domestic small cap stocks also posted a strong fourth quarter, with the Russell 2000 returning 14.0% for the quarter. Finally, bonds were not left out of this "everything rally" in the fourth quarter, with the Bloomberg Agg Bond Index returning 6.8%.

Total Returns	4Q	2023
S&P 500	11.7%	26.3%
DJIA	13.1%	16.2%
Nasdaq Composite	13.8%	44.7%
Russell 2000	14%	16.9%
MSCI EAFE	10.5%	18.9%
MSCI Emerging Markets	7.8%	10.1%
US Agg Bond Index	6.8%	5.5%

Source: Bloomberg, LP

An examination of these index returns for the full year illustrates the broadening of the market's performance in the fourth quarter. The Nasdaq Composite, led by the Magnificent Seven stocks, has been impressive all year. This aided the S&P 500, where those seven stocks comprise nearly 28% of the value of the index. They have a smaller contribution in the DJIA and no weight in the Russell 2000 or international indices. The performance of these other indices for the year is heavily influenced by their fourth quarter returns, with these indices having middling returns for the first three quarters of the year. Moreover, fixed income returns were negative for the first three quarters of the year.

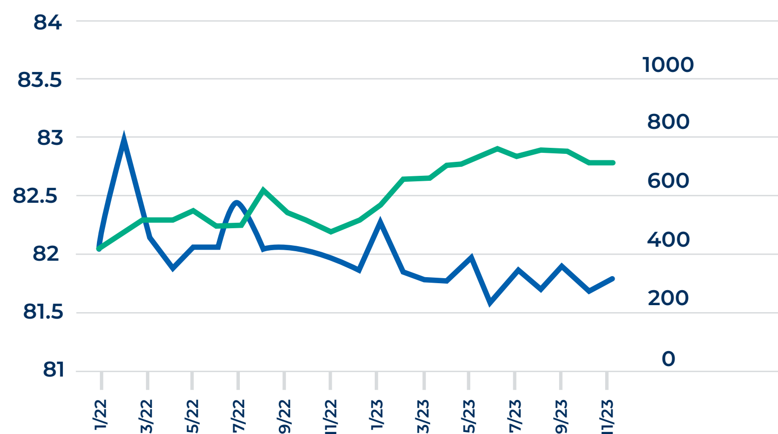
ECONOMIC CLIMATE

AS WE CONSIDERED OUR MESSAGE FOR A NEW YEAR, WE REREAD OUR NOTE FROM A YEAR AGO. WE WERE STRUCK BY HOW OUR TEAM AND MOST OF THE FINANCIAL WORLD WAS FAR TOO GLOOMY GOING INTO 2023.

The year began with economists surveyed by Bloomberg putting the odds of a recession in 2023 at 65%. As we try to forecast what 2024 may hold, it is instructive to understand why our team and many forecasters were so pessimistic about 2023.

The two largest drivers of economic activity in 2023 were government and consumer spending. The impact of fiscal policy was largely expected and driven by prior year policies, specifically the Chips Act, the Infrastructure Act, and the Inflation Reduction Act. This leaves the consumer as the surprise factor in driving stronger economic growth in 2023. Expectations for consumer spending as measured by Personal Consumption Expenditures (PCE) going into 2023 were for 0.9% growth, after 2.5% growth in 2022. This was predicated on rising unemployment, exhausted savings, and higher interest rates on revolving credit causing the consumer to become more cautious. Rather than a reduction in the growth rate of consumer spending, we saw it accelerate in 2023. The estimates for full year growth in PCE for 2023 are now 3.1%. With PCE accounting for 68% of economic activity, a strong US consumer leads to strong economic growth.

This consumer strength was caused by two factors. First, the labor market did not weaken as expected a year ago. The unemployment rate did tick up from 3.5% last December to 3.7% in December 2023, but this increase was for “good reasons”. During 2023, the US economy created 2.7 million jobs as measured by the Non-Farm Payroll report. Additionally, the labor force participation rate among 24–55-year-olds increased from 82.4% to 83.2%. The rate of growth in the labor market slowed as 2023 progressed but did not turn negative. The JOLTs report, which measures job openings, showed a 2.4 million reduction in job openings from December 2022 until November 2023. However, there are still 1.4 jobs for every unemployed person in the country, down from 2 jobs per unemployed person in the first half of 2022.



THE SECOND FACTOR SUPPORTING THE CONSUMER WAS FALLING INFLATION AND REAL WAGE GAINS.

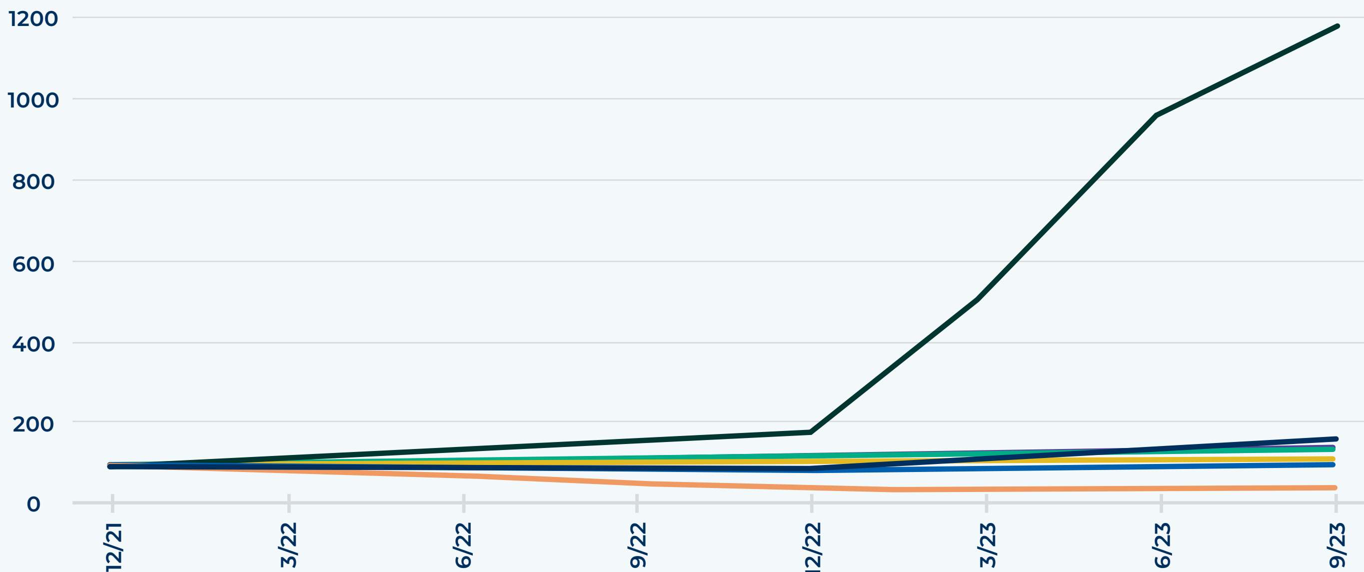
After twenty-five consecutive months of declining real average hourly earnings, real wage growth turned positive in May thanks to moderating inflation. Headline CPI fell from 6.5% in December 2022 to 3.1% in November, while Core Inflation fell from 5.7% to 4.0%. The consumer got a lift from gas prices, which fell 20% in the fall. Strong nominal wage growth and falling inflation increased consumer spending power in the second half of 2023. In summary, the reason the economy surprised to the upside last year was the resilient consumer.

EXPECTATIONS FOR 2024

WE WILL BEGIN WITH THE CONSENSUS ECONOMIC FORECAST FOR THE YEAR.

Expectations are for GDP growth of 1.3% in 2024, with slower growth in the first half, then picking up again in the last two quarters. Wall Street economists forecast a pickup in private investments and slower growth in consumer and government spending. Given the overly pessimistic expectations for 2023, we have tried to dissect these components to evaluate the Wall Street forecasts along with our own.

We believe private investments will turn positive in 2024. Private investment was additive to growth in 2Q and 3Q of 2023, led by manufacturing investments due to the Chips Act and onshoring. Manufacturing investment is less than 1% of GDP, but the increase in this sector has been substantial. Many of these are long lead time projects and investment will continue into 2024. We believe we will see an improvement in residential investments, after higher rates shocked home buyers and caused an underinvestment in housing. Demand for housing remains high, although affordability is a problem. Mortgage rates have fallen from 8.0% to 7.0% in the last few months, which helps affordability on the margin. Housing starts began to increase in late 2023 and we expect builders to deliver lower cost products to market to meet demand for new homes. We expect investment in intellectual property products to continue to grow in the high teens, as they did in 2023, to meet the demand for AI.



WE EXPECT GOVERNMENT SPENDING TO SLOW IN 2024 FROM THE FAST PACE OF 2023.

For 2023, government spending is estimated to have added 3.9% to GDP. As mentioned, much of this spending was set in motion years ago with the large packages passed by Congress coming out of the pandemic. There remain unspent dollars from the three large pieces of legislation, but we don't expect a deeply divided Congress to agree on any large new packages. There may be new spending on defense if a Ukraine, Israel and border deal is reached, though much of that spending will go overseas. Additionally, we are facing possible government shutdowns in the first quarter and a presidential election in November. The GOP will not give Biden any legislative wins going into an election. Government spending will continue to grow with inflation, but we don't expect it to add to growth in the way it did in 2023.

This leaves us with the US consumer, who powers most economic activity. Wall Street is forecasting a slowdown in consumer spending, from 3.1% growth in 2023 to 1.3% growth this year. This is predicated on an increase in the unemployment rate from 3.7% today to 4.2% next year. This forecast is eerily like that of a year ago, and the opposite occurred. Based on the current data, the job growth slowed in 2023, with the average monthly job gains in the first quarter of 312 thousand falling to 175 thousand in October and November. There has not been a noticeable uptick in initial claims for unemployment insurance, with the four-week average ending the year at 212 thousand, unchanged from the same week a year ago. As of November, there were 8.79 million job openings in the country, which is 2.5 million more openings than unemployed people. As inflation falls, workers are seeing wage gains adjusted for inflation, with seven consecutive months of positive year-over-year wage gains. We could see unemployment rise slightly in 2024, but we think the labor market will remain tight due to a lack of available workers, thanks to demographics.

We believe the US consumer is bifurcated going into 2024. Most are working and seeing wage gains, but those with assets are faring better than those with debt. Household net worth reached new all-time highs in 2023 and we expect the fourth quarter reading to post another new high thanks to strong equity market performance. But not all consumers own stocks or homes to see their net worth increase. Moreover, those who don't own assets are more likely to be younger and have large credit card and student loan balances. We think consumer spending will slow down some in 2024 as this cohort dedicates more of their wage increases to debt service, while the cohort with assets continues to spend freely. Another factor, which is longer-term in nature, is the great wealth transfer from boomers to their heirs. According to Cerulli Associates, boomers could pass down as much as $53 trillion to heirs and charities over the next few decades.

Of course, the primary driver of consumer spending is wages, and we expect the labor market to hold in 2024. For that reason, we think consumer spending may slow from the breakneck pace of 2023 but there is as much upside risk to the consensus on consumer spending as downside risk.

IF THE ECONOMY SLOWS TO ONLY 1.3% OR PERFORMS SLIGHTLY BETTER, WHAT WILL IT MEAN FOR MARKETS?

After a strong performance in 2023, Wall Street is more sanguine about equity returns for 2024. The average price target from 20 Wall Street Strategists for 2024-year end is 4,833, which is only 2.5% above the current index level. With a 1.5% dividend yield on the index, that would put the total return around 4.0%. Equity returns are a function of earnings and price multiples. The bottoms up consensus for 2024 earnings from Wall Street analysts is $244/share of the S&P 500. This would be a nearly 12% increase over 2023. This estimate is based on revenue growth of 5% and improving

profit margins as inflationary forces weaken. This level of revenue and earnings growth seems reasonable, particularly given the weak growth seen in 2023 outside of a handful of stocks. The margin pressures from higher costs for energy and certain raw materials has reversed versus a year ago and the pace of wage increases has slowed.

The next question is the multiple to place on these earnings. The trailing P/E ratio of the market is 21.8x and the forward P/E is 19.5x. These are skewed a bit by the Mag-7 stocks, but the market as a whole trades at a premium to long-term averages. A portion of the increase in share prices and valuation ratios was based on expectations of aggressive Fed rate cuts in 2024. Lower interest rates cause higher valuation measures for asset prices and here we face a disconnect between the market and the Fed going into 2024. The Fed, in their December meeting, signaled they expected to reduce rates by 0.75% in 2024 while the market is pricing in cuts of 1.5%. We believe the economy will continue to grow in 2024 and the consumer may be stronger than expected, and therefore we side with the Fed on fewer cuts. This may pressure valuation from these higher levels as the Fed takes longer to reach its long-term neutral rate of 2.5%-3.0%.

In that environment, we expect some of the areas that did not participate in 2023's strong returns to offer attractive returns. We believe there is value in sectors such as healthcare, financials, consumer staples, and utilities – to name a few. These parts of the market trailed the S&P 500 and the large growth stocks in 2023, and in many cases only began to provide returns in the fourth quarter. The valuations in these sectors are not as rich on an absolute basis, nor versus their historical levels. We don't expect a large drawdown in the higher valued stocks, but rather they will need to grow into these valuations if rates remain elevated.

ON THE FIXED INCOME FRONT, WE EXPECT THE YIELD CURVE TO SLOWLY DIS-INVERT AS SHORT-TERM RATES FALL AND LONG-TERM RATES REMAIN STABLE.

We do believe fixed income will continue to offer positive real returns for investors as inflation slowly moderates. We also believe we have returned to a more "normal" interest rate environment that existed prior to the Great Financial Crisis. The last 15 years were the anomaly with negative real rates, and we don't believe the Fed or other global central bankers will take us back to that environment.

Surely there will be surprises in 2024 that catch the markets off-guard, including the ones we are watching and ones we have not dreamt of yet. In the former category, the entire Middle East is a concern. Obviously, the war between Israel and Hamas is a tragedy, but the economic impacts on oil markets and Red Sea shipping routes could upend expectations for lower inflation. There is concern about commercial real estate and specifically office properties as loans mature in a higher rate environment, with lower vacancies due to the prevalence of the "work from home" ethos. We are watching the "known unknowns" and on the lookout for "unknown unknowns" that can impact the economy and markets in 2024.

But we are always optimistic about the future and know that management teams in the companies we and our clients own are also considering these uncertainties. We look forward to a new year and seeing how the economy and markets develop, with the exciting breakthroughs in AI, pharmaceuticals, and the rebuilding of parts of our manufacturing sector. It has never been good to bet against the long-term prospects of the United States and capitalism and we don't think that changes in 2024. **We wish our clients and friends a healthy and prosperous 2024 and look forward to seeing you all this year.**

THE MAGNIFICENT SEVEN'S IMPACT ON 2023

Last year was positive for all major equity indices and within the eleven sectors of the S&P 500, only utilities and energy finished the in red. While the fourth quarter saw a broadening of market strength across sectors, for much of the rest of 2023 it was the Magnificent Seven alone that fueled the market. An equal weighted index of those seven stocks returned 107% in 2023. These are the seven biggest weights in the S&P 500 and were responsible for nearly three-quarters of the benchmark's gains for the year.

Many of these stocks are leaders in Artificial Intelligence, which is the largest investment theme today. This has resulted not only in superior returns compared to the market, but also superior fundamentals. For 2023, the Mag-7 stocks were forecast to see 26% revenue growth and 19% earnings growth, compared to 6% sales growth for the S&P 500 and earnings growth of 2%. This growth is forecast to continue, with 2024 estimates for the Mag-7 showing revenue growth of 19% and earnings growth of 39%, compared to 5% and 11% respectively for the S&P.

The superior growth prospects for these companies, and others adjacent to AI, have increased the valuation ratios of these names. The forward price-to-earnings ratio of the Mag-7 index is 33.6x, compared to 19.5x for the S&P 500 and approximately 17.5x excluding the Mag-7. We believe AI will be a revolutionary technology and that many of these companies are on the forefront of this transformation.

We don't expect returns from these companies in the same magnitude as we saw in 2023. However, we were heartened to see the rally broaden out in the fourth quarter. For the first three quarters of 2023, the Mag-7 returned 83.9% and in the fourth quarter they returned 12.6%. The S&P 500 Equal Weight, which assumed the same dollar amount invested in each of the 500 companies in the index, returned 1.8% in the first three quarters of 2023, but soared 11.9% for the fourth quarter. This illustrates the broadening out of the market's participation after a concentrated rally in the first three quarters of 2023.

IN THE SPOTLIGHT

JORDAN TAYLOR
Director of Family Services

Jordan has a history in public accounting and C-store accounting. In public accounting, Jordan audited financial statements for various private companies and specialized in compliance audits. She has obtained a Masters of Accountancy and Bachelors of Accountancy from Clemson University. In addition, she is a Certified Public Accountant (CPA). Jordan runs the Family Office Service line, and she takes great pride in caring for our families and their financial needs. Jordan is a native to the Greenville area having grown up in Easley, SC and is now residing in Taylors, SC with her husband, Matthew. They are expecting their first child in June 2024.

Our Greenville team got into the holiday spirit, wrapping presents for the Christ Church Angel Tree.

OUR LEADERSHIP

H. Walter Barre

Bert D. Barre, CFA

Barry D. Wynn

Camp R. Wynn, CFA

Lorie L. Barton

Henry E. Batts III, AWMA®

Charles W. Clementson

James C. Fiske, CFP®

Jamison W. Hinds, JD

Thomas S. Ledbetter, Jr., CFA

Karen H. Longhurst, ATFA, CTFA

Pamela G. McCauley

Ansley J. Mitcham

Matt Van Name, CFP®, CRPS®, AIF®

Kathryn A. Smith, CPA/PFS, CFP®

Jordan R. Taylor, CPA

W. Charlton Wieters, CTFA

LOCATIONS

SPARTANBURG

233 S. Pine St.
Spartanburg, SC 29302

864.582.3356

GREENVILLE

101 E Washington St.,
Suite 200
Greenville, SC 29601

864.370.0737

COLUMBIA

6 Calendar Ct.,
Suite 1
Columbia, SC 29206

803.782.7646

CHARLESTON

578 East Bay St.,
Suite B
Charleston, SC 29403

843.577.0444

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